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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 78-746

EVA GROSSMANN, *Petitioner,*

v.

EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION CORPORATION,
Respondents.

On Petition For A Writ Of Certiorari
To The United States Court of Appeals For The Second Circuit

BRIEF IN OPPOSITION OF RESPONDENT SECURITIES INVESTOR PROTECTION CORPORATION

THEODORE H. FOCHT
General Counsel
900 Seventeenth Street, N.W., Suite 800
Washington, D.C. 20006
(202) 223-8400

Attorney for
SECURITIES INVESTOR PROTECTION
CORPORATION

Of Counsel:

WILFRED R. CARON
Associate General Counsel
MICHAEL E. DON
Senior Attorney

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On Petition For A Writ Of Certiorari
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BRIEF IN OPPOSITION OF RESPONDENT SECURITIES INVESTOR PROTECTION CORPORATION

QUESTION PRESENTED

Respondent Securities Investor Protection Corporation ("SIPC") respectfully submits that the five "Questions Presented" set forth in the Petition are imprecise and inadequate. The only question presented is:

> In a proceeding for the liquidation of a broker-dealer under the Securities Investor Protection Act of 1970[1] ("SIPA") should a subordinated lender

[1] 15 U.S.C. §§ 78aaa *et seq.* SIPA was amended in important and presently material respects in 1978. Pub. L. No. 95-283, 92 Stat. 249 (1978). Unless otherwise noted references and citations herein are to SIPA prior to the 1978 amendments.

to that broker-dealer be estopped for rescinding her subordination agreement, in order to obtain preferred "customer" status under SIPA, by reason of an overriding public policy requiring the enforcement of such agreements for the benefit of other creditors in light of financial responsibility rules promulgated under the federal securities laws, irrespective of proof of actual reliance on such agreement by securities customers of the broker-dealer?[2]

JURISDICTION

The Petitioner invokes the jurisdiction of this Court under 28 U.S.C. § 1254(1). However, this being a controversy in bankruptcy the jurisdiction of this Court is also primarily derived from 11 U.S.C. § 47(c).[3]

STATEMENT OF THE CASE

This case arises in a proceeding for the liquidation under SIPA of Weis Securities, Inc. ("Weis"), a former member of the New York Stock Exchange ("Exchange"). Petitioner is a subordinated lender to Weis by reason of her purchases of its subordinated debentures nearly six years prior to its demise. The Respondents are SIPC which commenced the liquidation proceeding, and Edward S. Redington, Esq. who was appointed the Trustee in liquidation.

Petitioner and over twenty other subordinated lenders of Weis filed claims with the Trustee asserting that they were entitled to rescind their subordination agreements and to be treated, in the distribution of Weis' assets, at least on a par with Weis' general creditors. Petitioner and some of the other subordinated lenders asserted, in addition, that upon rescission they should be treated as securities "customers" of Weis as that term is defined in SIPA [15 U.S.C. § 78fff (c)(2)(A)(ii)]. Thus they claimed the preferential treatment provided to customers including advances from SIPC's funds to satisfy their claims.[4] Most of these subordinated lenders grounded their claims for rescission on alleged fraudulent nondisclosure or misrepresentations by Weis of material facts relating to its financial condition as of late 1972 and early 1973.[5]

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[2] Despite the implication to the contrary in the Petitioner's statement of the "Questions Presented" and throughout the Petition itself, the nature of the relief to be afforded to the Petitioner is not yet ripe for decision. Accordingly, should this Court grant the writ of certiorari and subsequently answer the question presented in the negative, thus reversing the decision of the United States Court of Appeals for the Second Circuit, this case would have to be remanded for trial not only on the issue of reliance by members of the public but also as to the actual merits of Petitioner's asserted right to relief on various theories.

[3] *See, Mitchell Store Building Co.* v. *Carroll,* 232 U.S. 379 (1914). A liquidation proceeding under SIPA is substantially governed by provisions of the Bankruptcy Act except to the extent they are inconsistent with SIPA. *See,* 15 U.S.C. § 78fff(c)(1). Insofar as it provides for liquidation proceedings, SIPA is predominantly an exercise of the bankruptcy power of the Congress. *Exchange National Bank* v. *Wyatt,* 517 F.2d 453, 459-460 (2d Cir. 1975). The *Wyatt* case holds that appeals to the Court of Appeals are governed by § 24a of the Bankruptcy Act, 11 U.S.C. § 47a.

[4] The rights of "customers" were generally described in *SIPC* v. *Barbour,* 421 U.S. 412 (1975).

[5] The Trustee and SIPC have sued Weis' accountant in connection with its certification of financial statements for Weis which did not fairly represent Weis' financial condition at the time in question. That lawsuit is presently the subject of a writ of certiorari issued by this Court to the United States Court of Appeals for the Second Circuit. *Touche Ross & Co.* v. *Redington,* Dkt. No. 78-309.

However, Petitioner based her claim merely on her own lack of sophistication and on Weis' alleged failure, years earlier, to inform her that the loans which she admittedly knew would be used as part of Weis' capital would be subordinated to claims of other creditors.

Bankruptcy Judge Babitt denied the Trustee's motion for summary judgment, holding that the subordinated lenders could be estopped from rescinding only if the Trustee could prove actual reliance by Weis' customers and creditors on the subordination agreements. The district court (Wyatt, J.) reversed and the court of appeals affirmed the district court. The court of appeals, noting the importance of the regulatory structure of the securities industry, held that regardless of reliance by customers, ". . . where a lender subordinates his loan to a securities broker—to enable the broker to comply with regulatory capital requirements—he is estopped from rescinding the subordination agreement." (A13)[6]

REASONS FOR DENYING THE WRIT

I

PETITIONER HAS FAILED TO DEMONSTRATE THAT THE QUESTION PRESENTED IS "CERTWORTHY" WITHIN THE MEANING OF THIS COURT'S RULE 19 AND THE CRITERIA ESTABLISHED BY ITS DECISIONS.

Far From There Being A Conflict Among The Circuits Or With Applicable Decisions Of This Court, The Result Below Has Been Followed By Other Courts Considering The Same Matter, And Is Fully Consistent With Analogous Decisions Of This Court.

While Petitioner makes no claim that there is a conflict among the circuits, she does assert that the decision below is in conflict with applicable decisions of this Court within the meaning of Rule 19(b). Petition at 14. There is no such conflict. The holdings of both the court of appeals and the district court below are in full accord with a long line of federal and state cases which have required strict enforcement of the obligations of defrauded lenders or stockholders in the liquidations of banks and insurance companies—entities which, like stockbrokers, are affected with a considerable public interest and have been subject to comprehensive state or federal regulation. This line of cases includes a series of decisions by this Court. *See, e.g., Oppenheimer* v. *Harriman National Bank & Trust Co.,* 301 U.S. 206, 214 (1937); *Lantry* v. *Wallace,* 182 U.S. 536, 552-553 (1901); *Scott* v. *DeWeese,* 181 U.S. 202 (1901); *Julian* v. *Stewart,* 56 F.2d 32 (5th Cir. 1932); *Anderson* v. *Cronkleton,* 32 F.2d 170 (8th Cir. 1929); *Hurd* v. *Kelly,* 78 N.W. 588 (1879). In fact, and most recently, two district judges in another circuit, after independent analysis, followed the decision of the district court below. *Redington* v. *Exchange National Bank of Chicago,* Civil Action No. 75 C 2661 (N.D. Ill., November 8, 1977) and *Redington* v. *O'Hare International Bank,* Civil Action No. 75 C 2951 (N.D. Ill., March 21, 1978).[7]

There is clearly no need for this Court's intervention to reconcile opposing judicial views of the law.

[6] The reference is to page A13 of the Appendix to the Petition.

[7] No appeals were taken in either case and the time for appeals has passed.

This Case Does Not Involve ". . . An Important Question Of Federal Law Which Has Not Been, But Should Be, Settled By This Court . . . ." Congress Has Effectively Codified The Result Below By Recent Amendments To SIPA And Further Fortified That Result By Amending The Bankruptcy Act.

When this litigation arose the term "customers" was defined in SIPA to specifically *exclude* ". . . any person to the extent that such person has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor or is subordinated to the claims of creditors of the debtor . . . ." 15 U.S.C. § 78fff(c)(2)(A)(ii). Petitioner contends that, if allowed to rescind, she will escape this exclusionary clause and be deemed a customer of Weis entitled to preferential treatment under SIPA. Whether this is so or not,[8] the importance of this question has been vitiated because SIPC was amended in May of 1978 in a manner which effectively codifies the result below. The amended definition of "customers" specifically excludes:

> (B) Any person to the extent that such person has a claim for cash or securities which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor, or is subordinated to the claims of any or all creditors of the debtor, *notwithstanding that some ground exists for declaring such contract, agreement, or understanding void or voidable in a suit between the claimant and the debtor.*

Emphasis added. 15 U.S.C.A. § 78*lll*(3) (Supp. 2, 1978).

This amendment precludes rescission as a means of gaining "customer" status. It was suggested to the Congress by SIPC specifically because of this litigation. H.R. Rep. No. 95-746, 95th Cong. 1st Sess. 46-47 (1977); *See, id.* at 33-34.

In addition to amending SIPA, Congress also this year completely rewrote the Bankruptcy Act. The new Bankruptcy Act, which in pertinent part becomes effective in October of 1979, includes the following § 510(b) [11 U.S.C. § 510(b)]:

> Any claim for rescission of a purchase or sale of a security of the debtor or of an affiliate or for damages arising from the purchase or sale of such a security shall be subordinated for purposes of distribution to all claims and interests that are senior or equal to the claim or interest represented by such security.

The term "security" is defined in the new Bankruptcy Act to include "debentures" such as those purchased by Petitioner herein. 11 U.S.C. § 101(35)(A)(v). These provisions of the new Bankruptcy Act will apply in liquidations under SIPA pursuant to § 6(b) of SIPA as amended [15 U.S.C.A. § 78fff(b) (Supp. 2, 1978)], and as further amended by § 308(g) of the Bankruptcy Reform Act of 1978, Pub. L. No. 95-598.

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[8] Even if this Court takes this case and reverses the court of appeals, it is doubtful that Petitioner can obtain, after trial, the status of "customer". Not only will she have to prove the fraud which she has alleged and which to date has only been assumed for purposes of argument, but she will have to demonstrate that she fits the customer definition set forth in SIPA and that she *does not* fit into other portions of the exclusionary clause set forth above. For example, even with her subordination agreement rescinded, it may well be that Petitioner is a person who ". . . has a claim for property which by contract, agreement, or understanding, or by operation of law, is part of the capital of the debtor. . . ." It should be noted that Petitioner has admitted that she thought she was becoming a shareholder of Weis, a position even less envious than that of subordinated lender. (A73)

II

THE COURT OF APPEALS WAS CLEARLY CORRECT IN REJECTING PETITIONER'S CONTENTIONS AND IN HOLDING THAT SUBORDINATED LENDERS WHOSE LOANS WERE USED TO ENABLE THE STOCKBROKER TO COMPLY WITH "REGULATORY CAPITAL REQUIREMENTS" MAY NOT RESCIND THEIR SUBORDINATION AGREEMENTS, EVEN ABSENT PROOF OF ACTUAL RELIANCE BY CUSTOMERS.

The court of appeals based its holding in principal part ". . . on considerations of sound public policy" (A12) manifested by the system of regulation to which Weis was subject. As the court stated (A9):

> . . . [T]he instant case involves the attempted rescission of a promise or obligation intended to allow a company to satisfy regulatory requirements and of promises made by the company to regulatory authorities. We therefore have an additional factor—regulatory interest—to consider in determining whether it is here "reasonable and necessary" to require reliance on the subordination agreements. Our inquiry must focus on whether the element of reliance has any place in the regulatory scheme of Congress.

The "regulatory requirements" referred to by the court of appeals are primarily the "net capital" rules of the Securities and Exchange Commission ("SEC") and the Exchange. The "promises" are those made by lenders in their subordination agreements which must be approved by the Exchange.[9]

[9] A subordination agreement must be approved by the Exchange before it becomes effective. The Exchange requires the agreement to subordinate the lender's claim to the claims of all other creditors of the broker-dealer; to waive any right to participate in the assets of the broker-dealer's estate until the claims of all other creditors have been satisfied in full; and to contain provisions preventing the lender from withdrawing his property before the expiration date of the loan without the written consent of the Exchange, and precluding withdrawals even upon expiration if the broker-dealer is insolvent or in violation of the net capital rules. Pp. 167-68, 226, 268-69, 303-04, and 325-26 of the Joint Appendix in the court of appeals.

The "net capital" of a broker or dealer is essentially his adjusted "net worth", as defined in SEC Rule 15c3-1 [17 C.F.R. § 240.15c3-1]. "[T]he principal purpose of the rule is to require that the capital position of a broker or dealer will always be sufficiently liquid to cover his current obligations, in order to be able at all times to promptly meet the demands of customers." Securities Exchange Act Release No. 8024 (January 18, 1967). As a member of the Exchange, Weis was exempt from the SEC's net capital requirements [10] and was subject to the more stringent net capital requirements of Exchange Rule 325 promulgated pursuant to section 6(d) of the Securities Exchange Act of 1934. The net capital rule is the "principal regulatory tool" used to monitor the financial soundness of brokers and dealers. Press Release, January 10, 1973 [1972-73 Transfer Binder] Fed. Sec. L. Rep. (CCH), ¶ 79,174 at 82,578 (remarks of Senator Harrison A. Williams, Chairman of the Senate Securities Subcommittee). The courts have described the rule as "one of the most important weapons in the Commission's arsenal to protect investors", *Blaise D'Antoni & Associates, Inc.* v. *SEC*, 289 F.2d 276, 277 (5th Cir.), *cert. denied*, 368 U.S. 899 (1961) and as "one of the most important provisions

[10] SEC Rule 15c3-1(b)(2) exempts members in good standing of certain national securities exchanges. The exemption is granted by the SEC following its review of the exchange rule and determination that the exchange rule is more comprehensive. See, Securities Exchange Act Release No. 3617 (Nov. 8, 1944).

designed to protect the investing public . . . ." *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, 534 F.2d 156, 173 (9th Cir. 1976)."

Subordinated loans play a unique and vital role in the financing of stockbrokers and the operation of the net capital rule. In computing a brokerage firm's net capital ratio, subordinated loans are excluded from aggregate indebtedness and included in net capital. "The subordination of a loan thus has the effect of converting what would otherwise be a liability into a net capital asset." Wolfson & Guttman, *The Net Capital Rules For Brokers And Dealers*, 24 Stan. L. Rev. 603, 624 (1972) (hereinafter "Wolfson & Guttman"). A subordinated lender makes his rights subordinate to those ". . . of the three major classes of creditors of the broker or dealer, his customers, banks, or other brokers or dealers, and to the rights of all his other general creditors as well . . . . Since the subordination is intended to assure the customers will be protected, the subordinated loan is assumed to contain sufficient characteristics of equity to warrant its inclusion in net capital." *Id.* at 625.

The use of subordinated liabilities as part of a firm's capital is one of the key elements in providing the liquidity which is a primary objective of the net capital rule. *See,* E. Weiss, *Registration And Regulation Of Brokers And Dealers* 58 (1965). "It may be noted that no other means than a satisfactory subordination agreement can be utilized to accord a liability the treatment of being added to capital for purposes of the

[11] The importance of the net capital rule far outweighs Petitioner's interest in enforcement of Exchange Rule 405, contrary to her contentions otherwise. Petition at 11-14, 15-16.

net capital rule." *Id.* at 67. The availability of this capital is vitally important to customers of brokerage firms. Its sudden withdrawal can spell disaster for the firm and its customers. Wolfson & Guttman, *supra,* at 625; *see,* H. Baruch, *Wall Street: Security Risk* 177-179 (1971).

The court of appeals considered the regulatory context of this case and decided that proof of actual reliance by customers was unnecessary in order to estop rescission by Petitioner and the other subordinated lenders. As noted above (at p. 5) the court relied heavily on a long line of state and federal cases, including decisions of this Court, establishing that lenders and shareholders in companies in the heavily regulated banking and insurance communities would not be allowed to rescind their agreements and thereby adversely affect the interests of creditors of those companies in liquidation.

Petitioner's Miscellaneous Arguments Lack Merit

The Petition depicts a hyperbolic scenario of adverse consequences on a grand national scale stemming from the decision sought to be reviewed. *See, e.g.,* Petition at pp. 8, 10-11. Beneath the rhetoric, however, there is little to merit the attention of this Court. Petitioner's principal contentions have been answered above. Her subsidiary contention appears to be that she has been denied common law and state statutory rights which Congress intended to preserve for her.

There is, of course, no common law or state statutory right to the protections afforded to customers under SIPA. In any case, whatever rights Petitioner has at common law or under Illinois statutes can be pursued

against the agent of Weis who sold her the debentures, the Exchange, or any other allegedly responsible party. The decision below has no effect on those rights.

Petitioner's assertion that a constructive trust should be imposed for her benefit on property in the Trustee's hands is without merit. In the first place, although Petitioner asserts (Petition at 5-6) that Weis failed to point out to her that her loan would be subordinated and failed to explain the subordination clause in her debenture, she admits the practical equivalent, namely, that she "... thought at the time of the investment that these debentures were really . . . shares of stock in Weis . . . ." (A73) (Petitioner's Affidavit). For nearly six years she received a high rate of return on her investment, which eventually went bad for reasons no one could foresee in 1967. Moreover, there is nothing to which a constructive trust could attach. Petitioner admits (Petition at 17) that her payments for the subordinated debentures became part of Weis' working capital. Accordingly, there is no fund of property to which Petitioner can trace her money. *See,* 4A *Collier on Bankruptcy* ¶ 70.25[2] at 354-56 (14th ed. 1978).[12]

[12] "Once the trust relationship has been established, one claiming as a *cestui que trust* thereunder must identify the trust fund or property in the bankrupt estate and, if such fund or property has been mingled with the general property of the bankrupt, sufficiently trace the trust property. In other words, to sustain a claim to trust property or to an equitable lien thereon, the claimant must depend upon his ability to identify the property in its original or substituted form in the hands of the bankruptcy trustee. The basic idea of the trust doctrine as applied in bankruptcy is a fair and reasonable identification of the property or fund so as not to harm other creditors. It is not enough, therefore, to show merely that the funds or property came into the bankrupt's hands or went into the bankrupt's business or, by the better view, even that the funds or property are contained somewhere in the bankrupt's estate." Footnotes omitted.

Petitioner's apparent assertion (Petition at 17-18) that because her money became part of Weis' capital nearly six years before this proceeding she is, as a matter of law, entitled to the imposition of a constructive trust on funds in the Trustee's possession, is simply to ignore the entire doctrine of the tracing of commingled funds.

CONCLUSION

Respondent SIPC respectfully submits that the Petition for a Writ of Certiorari should be denied.

Respectfully submitted,

THEODORE H. FOCHT
General Counsel
900 Seventeenth Street, N.W., Suite 800
Washington, D.C. 20006
(202) 223-8400

Attorney for
SECURITIES INVESTOR PROTECTION CORPORATION

Of Counsel:

WILFRED R. CARON
Associate General Counsel

MICHAEL E. DON
Senior Attorney